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HOUSE OF COMMONS OF CANADA
35th PARLIAMENT, 1st SESSION

SPEECHES: GOVERNOR. =

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EVIDENCE

Standing Committee
on

FINANCE

Chair: Jim Peterson

Meeting No. 151

Tuesday, August 15, 1995



ORDER OF THE DAY:

Pursuant to Standing Order 73(1), the Committee undertook consideration of Bill C-100, An Act to amend, enact and repeal certain laws relating to financial institutions

APPEARING:

The Honourable Doug Peters, Secretary of State (International Financial Institutions)

WITNESSES:

Bank of Canada:

Gordon G. Thiessen, Governor.

Canadian Actuaries Institute:

Morris W. Chambers, Chairman of the Task Force on insurance legislation;

Marc Fernet, President.

Office of the Superintendent of Financial Institutions:

Nick Le Pan, Deputy Superintendent;

John Palmer, Superintendent.

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EVIDENCE

[Recorded by Electronic Apparatus]

Tuesday, August 15, 1995

Our next witness is no stranger to us: the Governor of the Bank of Canada, Gordon Thiessen. He is accompanied by Robert Turnbull and Clyde Goodlet.

Welcome. We look forward to your presentation.

Mr. Gordon G. Thiessen (Governor of the Bank of Canada): Thank you, Mr. Chairman.

As you say, I indeed have with me Clyde Goodlet, who is an adviser in our monetary and financial analysis department, and Robert Turnbull, from our legal affairs group.

[Translation]

I am very pleased to appear before you today as part of your examination of Bill C-100.

In my opening statement, I would like to focus on that part of the bill with which the Bank is most directly involved: the proposed Payment Clearing and Settlement Act.

[English]

The provisions in this part of the bill are designed to contribute to the development of sound clearing and settlement systems in Canada. Clearing and settlement systems really are at the heart of our financial system. They provide the means whereby transactions of all kinds in our economy, from ordinary payments by cheque or credit card to large purchases and sales of securities and currencies, are completed.

The Bank of Canada is centrally involved in these arrangements because final settlement among financial institutions of these transactions takes place through transfers of funds between the deposit accounts that these financial institutions hold with us. The bank has a particular interest in the security and soundness of clearing and settlement systems because of our responsibility as lender of last resort in the Canadian financial system. Weaknesses in clearing and settlement arrangements have the potential to disrupt the operation of financial markets and create severe problems for participants in the financial system, and that can have wider spill-over effects for users of financial services, and indeed for us in our implementation of monetary policy.

[Translation]

Like other central banks around the world, the Bank of Canada has watched some concern the massive increases in the value of transactions flowing through the financial system, and the expanded linkages between domestic and foreign financial systems. The potential for problems in

one area of the financial system - here to spread elsewhere has increased. This potential is what we refer to as systemic risk.

[English]

Here in Canada there have been some particular areas of concern. Until recently, most of the arrangements for handling payments and other financial transactions have been based on paper cheques, security certificates, etc., and this has meant that the processing of these transactions takes time. This time-lag raises the risk that a participant to a transaction or a financial institution may fail before the settlement of the transaction is absolutely final.

Take an example in our paper-based payment system, which is very efficient. There is a lag of at least one day before the recipient of a payment can be certain that the payment has been processed and the funds that he or she has received are absolutely irrevocable. For payments that are big enough to be crucial for the recipient, the resulting risk can be great.

Canada is the only major industrial country without a system that provides finality for same-day large-value payments.

Because of the risks inherent in the lags in paper-based systems, the bank has been an enthusiastic supporter of initiatives to establish automated systems in Canada that speed up the handling of financial transactions. In the case of securities transactions, there is the initiative of the Canadian Depository for Securities to establish a system that permits the immediate electronic transfer of and organizes the payment for Government of Canada securities, and ultimately may cover other securities as well.

In the payments area, the Canadian Payments Association has undertaken to design and operate a system to handle large-value payments for same-day settlement - the LVTS, as it's known. Also, in the foreign exchange area there are a couple of private sector initiatives that aim at improving and reducing risk associated with the clearing and settlement of foreign exchange transactions and payments.

However, these initiatives, which speed up the settlement of financial transactions and thereby reduce the risk associated with transaction lags, have the effect of concentrating large numbers of transactions in a single automated system. Thus, it is important that the operating arrangements for these systems are robust enough to handle other potential risks, particularly the possibility of the failure of a participating institution that could in turn cause the failure of other participants, and indeed of the clearing and settlement system itself.

The Bank of Canada, in conjunction with the Department of Finance, the Office of the Superintendent of Financial Institutions, and the Canada Deposit Insurance Corporation, has worked with the private sector to develop appropriate risk control mechanisms for all these initiatives. Because of our central role in the payment system and because of our involvement in the discussions with other central banks around the world in this area, the bank has taken a lead in this work.

The proposed payment clearing and settlement act in Bill C-100 would give the Bank of Canada a more formal and explicit role in the oversight of clearing and settlement systems, with the objective of controlling systemic risk. This formal oversight responsibility would mean that private sector operators of those clearing and settlement systems that potentially pose systemic risks would be required to obtain the approval of the bank regarding the arrangements in their system to monitor and control risks.

To carry out this responsibility, the act would provide the bank with information gathering powers to determine where there is potential for systemic risk, and for those systems where that potential exists it provides the bank with the capacity to ensure that the system is operated in a safe and sound manner.

[Translation]

It is important to note that the legislation aims to only supervise the systems with potential systemic risk, and does not seek to regulate any associated financial market. Thus, a clearing and settlement system for securities could come under legislation without implying federal regulation of the securities markets.

In addition, the proposed act would provide the Bank with the capacity to become a direct participant in these systems and to provide services to them. Two powers worthy of special mention concern the ability of the Bank to provide a guarantee of settlement to the participants of designated systems and the ability to pay interest on special deposits accepted from the clearing house or from the participants in the clearing and settlement system.

[English]

This guarantee would be provided only to the LVTS system being developed. This system is being designed to meet the internationally agreed standard that it must be able to withstand the failure of its single largest participant without putting other financial institutions in the system at risk as a consequence.

However, there does exist an extremely remote possibility that more than one financial institution could fail during the business hours of a single day. This is unlikely in the extreme; nonetheless, it's necessary to deal explicitly with this possibility to permit the financial institutions participating in the LVTS to offer their customers absolute assurance that an LVTS transaction cannot be reversed, no matter what happens.

To facilitate this outcome, the legislation proposes that the Bank of Canada should provide a guarantee that the LVTS will settle all transactions, even in the exceedingly improbable event of the failure of more than one participating institution during the time when the LVTS is open for business.

A claim on this guarantee would occur only to the extent that the losses on the LVTS exceeded the major commitment to cover losses by private sector participants.

This guarantee would benefit the payment system as a whole, but would not provide support for failed financial institutions.

It is also important that this new system for large-value payment should be available to a wide range of users in the community at a reasonable cost. To minimize the costs of the system, to minimize the costs of the collateral required for a properly risk-proofed LVTS, the legislation proposes giving the Bank of Canada power to create a special form of collateral. This would consist of special one-day deposits held by participating financial institutions at the bank, on which we would pay a one-day rate of interest. The benefit of these deposits is that they would be available to back-stop the commitment of participating financial institutions to cover losses on the LVTS.

Let me conclude by reiterating that the Bank of Canada strongly supports the federal government's initiatives in Bill C-100 to bring about well-designed clearing and settlement arrangements in Canada. Such arrangements have the potential to strengthen the efficiency, soundness, and stability of our financial system.

Other countries have recognized the problems with their existing arrangements and are moving rapidly to develop better payment, clearing, and settlement systems. It is important that we in Canada do not fall behind and thereby impede our ability to compete in an increasingly international market in financial services.

[Translation]

The Chair: Thank you, Mr. Thiessen. Mr. Loubier, do you have some questions for Mr. Thiessen?